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The Honorable Carl Levin
U.S. Senate
Washington, D.C. 20510

Dear Senator Levin:

We are writing to offer our enthusiastic support for your draft legislation, "The Auditor Independence and Tax Shelters Act," which would shore up the auditor independence reforms of last year's landmark corporate reform legislation. Unfortunately, when the Securities and Exchange Commission adopted rules to implement the Sarbanes-Oxley Act's key auditor independence reforms, it made concessions to the audit firms that threaten to undermine the law's effectiveness in promoting more independent audits. Your legislation directly addresses two of the most serious of those concerns. **Passage of this bill is one of the most important steps Congress could take to ensure that last year's corporate reform efforts have their intended effect of restoring real independence to the "independent" audit and, with it, a reasonable level of reliability to public companies' financial disclosures.**

As you know, the Sarbanes-Oxley Act prohibited auditors from providing certain non-audit services to audit clients because they violate basic principles of auditor independence. Recognizing, however, that no such list will ever be all-inclusive, the legislation's authors supplemented that ban with a requirement that audit committees pre-approve all non-audit services, including tax services. The clear intent was that audit committees would use this process to protect the independence of the audit and would do so by reviewing non-audit services proposed to be provided by the auditor to determine whether they too violate basic principles of auditor independence.

That approach is consistent with the guidance provided by then SEC Chairman Arthur Levitt when he wrote to audit committees in January of 2001 to urge them to pre-approve non-audit services and to take these principles into account as part of their decision-making process. The major audit firms, however, have painted a very different, and we believe fundamentally misleading, picture of the role of the pre-approval process. They have suggested that Congress

intended to draw a "clear line" around a set group of prohibited non-audit services and affirm the legality of all others. They have also suggested that the basic principles of auditor independence are too vague to be effectively applied by audit committees to decisions over whether to pre-approve specific non-audit services. If such an interpretation gains adherents – and at least some in the industry are actively promoting it to audit clients – the pre-approval process threatens to become a meaningless exercise with no value in maintaining the independence of the audit.

1. We support codifying the basic auditor independence principles and requiring audit committees to evaluate non-audit services for violations of those principles.

Your legislation would directly address this problem by codifying the basic principles of auditor independence and by clarifying that audit committees must take them into account when deciding whether to engage the auditor to provide non-audit services. We strongly support this reform. Although we recognized the intense political pressure the SEC faced when it adopted its 2000 auditor independence rules, we objected strenuously to its decision to move these principles from the rule language, as originally proposed, to the preamble, where they lack the force of law. Had the SEC known then what Enron and Worldcom and a host of other corporate disasters have since taught us, it is a concession we are sure the agency would never have made.

This reform also makes simple, basic sense. The Senate report language makes clear that the legislation's list of prohibited non-audit services are prohibited *expressly because* they have been found to violate these basic principles. In that case, it makes far more sense to codify the principles than to try to continually review and update a list of prohibited services based on those principles. Such an effort can never hope to keep pace with a rapidly evolving marketplace and will inevitably leave loopholes (as the discussion of tax services below makes clear). Although the audit committee pre-approval requirement is supposed to ensure that such conflicts are avoided, it will only do so if audit committees are aggressive in applying the basic principles of auditor independence in their review of non-audit services.

It would seem perfectly evident that this is the approach Congress intended when it adopted the pre-approval requirement, but is not clear that everyone shares that understanding. At least one major audit firm, Ernst & Young, appears to be actively promoting to audit clients what we view as a totally inappropriate approach to the pre-approval process. While we might question why, in this day and age, an audit committee would trust its auditor for advice on maintaining the independence of the audit, we have no doubt that more than a few will do so. Mandating through legislation that audit committees consider these basic principles of auditor independence in reviewing non-audit services should once and for all remove any doubt about audit committee responsibilities.

2. We support banning auditors from providing tax shelter services to public companies they audit and to the executives and officers of those companies.

While it may have made sense at the time Congress adopted the Sarbanes-Oxley Act to rely on audit committee pre-approval to sort out issues related to permissible tax services, recent events have demonstrated the need for stricter limits.

- First, Sprint announced that it was firing its top executives, rather than dismiss its auditor, because of conflicts resulting from the auditor's highly lucrative sale of controversial tax shelters to those executives. There is no reason to believe that the Sprint case is an isolated example, except that the board of directors chose to act to eliminate the conflict. This raises the question of how many other public companies have similar conflicts that have not been addressed.

- Second, the Joint Committee on Taxation released it official report on its investigation into the collapse of Enron, laying out the substantial role that promoters of and advisers on tax strategies played in the downfall of that company. As Senators Charles Grassley, Chairman, and Max Baucus, Ranking Member, of the Committee on Finance, wrote in a March letter to SEC Chairman William Donaldson, "Enron's use of a close web of tax promoters and advisers – accountants, lawyers, and investment bankers – to construct complex schemes to avoid taxes and manipulate the financial statements raises serious questions regarding the roles played by these promoters and advisers." Again, there is no reason to believe Enron is alone in this.

In an oversight that is evident in hindsight, the SEC auditor independence rule does not address the issue of conflicts that arise when auditors provide tax planning services to executives at the corporations they audit. Yet, if you apply the reasonable investor test – would a reasonable investor perceive this as a conflict – the answer is clearly yes. Providing tax consulting to executives can result in the auditor's having to advise management on tax positions that may conflict with the best interests of the company and its shareholders. As such, this practice should clearly be banned.

The more fundamental question, however, is how we can continue to allow auditors to help their audit clients devise schemes with no purpose but to reduce taxes and still act as "independent" public watchdogs. Unfortunately, the SEC actually muddied the water on this issue in its auditor independence rules. After noting in its proposing release the substantial conflicts that can be associated with tax planning services, the agency bowed to industry pressure and not only removed that language from the final rule release but also "reiterate[d] its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence." Because of the conflicts inherent in this dual role, and because of the SEC's failure to handle the issue effectively, we believe your legislation offers the best approach to resolving this problem, by banning auditors from providing tax shelter services to audit clients.

3. Legislation is needed to resolve these issues.

We have communicated our concerns in each of these areas to SEC Chairman William Donaldson and other members of the Commission. Among other things, we have specifically urged the Commission: to codify the basic principles of auditor independence; to clarify that audit committees must consider these principles in approving non-audit services; and to ban

auditors from acting as an advocate regarding tax matters, including by providing tax shelter services to the companies they audit or to their audit clients' executives.

While we hold out some hope that Chairman Donaldson will act on these concerns – since the development of and vote on auditor independence rules did not occur on his watch – that outcome is by no means guaranteed. The sad truth is that, in implementing this central reform on the Sarbanes-Oxley Act, the SEC showed itself to be remarkably accommodating to the audit firms and disturbingly indifferent to the concerns raised by investor advocates. Your legislation identifies two of the most serious flaws in the current auditor independence rules and offers a simple and sensible solution. Please let us know what we can do to help win its passage.

Sincerely,

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